

Nova Law Review

Volume 28, Issue 2

2004

Article 5

Sarbanes-Oxley Act of 2002, Congress’ Response to Corporate Scndals: Will the New Rules Guarantee “Good” Governance and Avoid Future Scandals?

Aulana Peters*

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SARBANES-OXLEY ACT OF 2002, CONGRESS' RESPONSE TO CORPORATE SCANDALS: WILL THE NEW RULES GUARANTEE “GOOD” GOVERNANCE AND AVOID FUTURE SCANDALS?

AULANA PETERS

On June 26, 2002, an article in the Washington Post quoted the Chief Economist at Morgan Stanley as saying “[t]he economy and markets right now are in the midst of a full-blown corporate governance shock . . . to presume somehow that it is over or the worst is behind us is naïve.” A few weeks later, Congress passed the Sarbanes-Oxley bill, which mandated sweeping changes in the governance of publicly held companies in the United States. Congressional action had been preceded many months prior by the markets amending their listing standards to address perceived deficiencies in the corporate governance of listed companies. There is not much debate about whether Sarbanes-Oxley is the most significant piece of securities regulation adopted since the passage of the 1975 amendments to the Securities and Exchange Act of 1934. Its significance lies partially in the fact that it goes far beyond requiring specific financial disclosures of corporate issuers and imposing enhanced penalties for violations of such requirements. It also addresses directly areas such as corporate governance, auditor independence, and the self-regulatory structure for the accounting profession that traditionally have been solely within the purview of the states and the private sector. This is an unprecedented action.

The Congressional mandate and the SRO's action are being implemented through SEC rules. It has been a very, very busy couple of months for the SEC and the pressure is still on. Sarbanes-Oxley and the new listing standards are far-reaching and wide-ranging in scope. It would require an entire course to deal with each of its provisions; therefore, this seminar will deal with only certain portions of the Act and the related listing standards, principally those specifically directed at corporate governance and analyst's perceived conflicts of interest. I do not intend to cover the language of the act or rules or attempt to interpret the provisions for you. We will take them at face value. My approach will be to discuss or analyze the corporate governance provisions and the analyst provision with a view to exploring whether implementation of the rules is likely to achieve the goals of the Congress and the markets—improved corporate governance and conflict free research.

(What value can I offer as a non-academic—experience and knowledge based on the processes and dynamics of the courtroom, the regulatory and self-regulatory environment and the boardroom)?

CORPORATE RESPONSIBILITY

The conventional wisdom is that “good” corporate governance will generally work, to the benefit of a company’s shareholders. Indeed this premise was reiterated in a recently published paper by Salomon Smith Barney, which stated, “[t]he quality of corporate governance can be an important driver of shareholder value that companies with strong corporate governance have outperformed peers in a wide range of settings.” Many argue that “good” corporate governance will also ensure good financial reporting and avoid corporate misfeasance. These two principles have become articles of faith with many corporate governance experts and serve as the primary rationale for the modification of listing standards proposed by the markets and adopted by the Securities and Exchange Commission.

The sweeping changes mandated by Sarbanes-Oxley and the new listing standards are a significant sea change for most companies, even though many provisions are already considered best practices for others. Certainly Congress and the markets believed, or professed to believe that these changes or reforms (as some like to call them) will improve corporate governance to an extent that will avoid a recurrence of the scandals like Enron, WorldCom, Xerox, and Arthur Anderson. That being the case, it would be beneficial to have a reality check on just how effective these corporate governance rules, principally implemented through oversight by “independent” directors, are in protecting the interests of shareholders.

There is no question that corporate governance, including strong independent audit, compensation and nominating committees, ultimately rebounds to the benefit of shareholders by making management more accountable. However, it is still open for debate as to what constitutes “good” corporate governance. Therefore, one can justifiably question whether “good” corporate governance rules (assuming one could agree on the definition) guarantee accurate financial reporting, prevent bad judgment, or eliminate venality in management.

Sarbanes-Oxley (and the SEC rules adopted pursuant to the Act) requires Audit Committees to be fully “independent” and requires that the audit committee hire and supervise the independent auditors. The NYSE/NASDAQ listing standards (and the SEC rules implementing them) define minimum standards of independence, mandate certain communications between independent auditors and audit committees require that Board meet in executive session, and the audit committee meet periodically with

the internal and external auditor without management. In addition, the NYSE recommends, without mandating it, that Boards consider separating the positions of Chairman of the Board from Chief Executive Officer and or electing a "Lead Director" to chair the Board's executive sessions and act as liaison with management. The stated objective of these rules and recommendations is to ensure "good" corporate governance, however, that may be defined, which in turn is expected to eliminate or reduce the risk of scandals like Enron, Xerox, Global Crossings, WorldCom, and Ahold in the UK. The question I would like to address today is whether the changes are for the better, the worse, or neutral.

Leaving the really difficult task of defining what constitutes "good" corporate governance for another time, it is nevertheless beneficial to evaluate the implications of the "reforms" so that one's expectations for the extent of substantive improvement in corporate behavior are realistic. In this regard, it is worth pointing out that the Corporate Governance structure of Enron would have passed muster under the new NYSE rules. In fact, there is anecdotal evidence that a majority of the Fortune 500 already had in place fully independent audit committees, as required by Sarbanes-Oxley, as well as many, if not most, of the requirements proposed by the new NYSE/NASD listing standards. Other requirements that were already considered best practices and in place at many companies, include: 1) Increased role and authority of independent directors; 2) Requirement that independent directors be the majority of the Board; 3) Requirement that the non-management directors meet in executive session on a regular basis; 4) Mandate that shareholders vote on all equity based compensation plans, including stock option Plans; 5) Requirement that Audit, Compensation, and Nominating Committees consist solely of independent directors, with a requirement that the Chair of the Audit Committee have an accounting or financial management experience; 6) Mandate that listed companies adopt and publish Codes of Business Conduct and Ethics.

Other standards are new, for example: 1) Placing sole authority to hire, compensate, and terminate the independent; 2) Auditor in the hands of the Audit Committee; 3) The adoption and publication of corporate governance Guidelines; 4) The NYSE recommendation that Boards establish an orientation program for directors; 5) Tightening the definition of "independent director", including a 5-year cooling off period for, among others, former employees of the company, its auditor, and requiring the Board to affirmatively find that each director has no material relationship with the company; 6) Mandate that director compensation represent the sole remuneration from the company for audit committee members; and 7) Require the CEOs of NYSE listed companies to attest to having established and complied with internal controls designed to ensure accuracy and completeness of information pro-

vided to investors. The Sarbanes-Oxley act requires the CEO and CFO to certify financial reports.

For this analysis, it may be helpful to keep in mind a fairly cynical definition of a "corporation" attributed to Ambrose Bierce who described it as an "ingenious device for obtaining individual profit with individual responsibility." Well, if the individual investor/shareholder shoulders no responsibility, who does? Clearly Management shoulders responsibility, but also, to an increasing degree, the Board of Directors. However, it is important to remember that independent members of a company's Board of Directors are charged with *oversight* of corporate management. The directors do not, and are not expected to, manage the corporation itself. Because they are not involved in a company's business on a daily basis, they can not be expected to know, or be in a position to know, the details of every business transaction, the vulnerability of every aspect of the corporate internal control system, or every potential conflict of interest that may lurk behind management's recommendations.

For this reason, I think it is important to keep in mind three key points. First, to the extent that listing standards and SEC rules are designed to facilitate the flow of information from management, auditors, and other advisors, to shareholders and boards of directors, to the extent that the standards provide an opportunity for and encourage directors to probe and test management's decisions. It is reasonable to expect that they will, indeed, have a positive effect on the interests of shareholders.

Second, to the extent the "reforms" are designed to try to eliminate the potential harm that may arise out of the conflicts of interests inherent in our capitalist system, they are likely to be only marginally effective in protecting shareholders and investors from venal corporate executives, if any there be. In other words, they are neutral to Corporate Governance, but may be detrimental under some circumstances.

Two astute observers of the modern western cultural and social dynamic have clearly understood the conundrum that arises from the West's belief that unfettered quest for individual wealth affects the community at large. George Bernard Shaw once said, "[m]ake money and the whole nation will conspire to call you a gentleman." Mark Twain echoed a similar view when he said, "[v]irtue has never been as respectable as money." These observations are as applicable to contemporary times as they were at the turn of the last century and provide a touchstone for the reality check to which I referred earlier.

With respect to the first point, in my opinion, listing standards designed to improve the flow of information from Management to the Board, between the Board and its outside and inside professional experts (lawyers, auditors and accountants) most definitely benefit shareholders' interest. Experience

has proven that opening lines of communication are essential if Boards of Directors and particularly, audit committees are to do their job. Without the ability to obtain timely information and the means to test and probe the information received, directors will not be in a position to monitor management's business strategies and financial reporting activities or the outside auditors' review and testing of those business strategies and reporting activities. Thus, such reforms are an improvement of Corporate Governance.

With respect to my second point, many of the new rules focus on compensating for real and perceived conflicts of interest. However, you cannot eliminate bad judgment with rules. The value of these new standards should be measured by the views of Mr. Beirce on corporations and Mr. Shaw and Twain on money. Those views, of course are very cynical; however, it is difficult to deny that they are well-grounded in our nation's cultural and economic fabric. That is not to say that rules in general, and listing standards in particular, cannot be useful tools in efforts to corral greed, bad judgment, and general venality. I simply believe that we should be realistic about the long-term chances for success.

Absent an environment that informs the Board and its committees and encourages them to ask pointed, tough questions about management's policies, practices and procedures, test management's decisions, and developing confidence in the quality of the work of outside experts, Boards will not be in a position to get comfortable enough to conclude that management and the professionals on whom they rely are doing their jobs properly. Several of the changes made to listing standards as a result of the 1998 Blue Ribbon committee and those adopted by the markets last Fall are designed to achieve precisely this goal.

Currently, listing standards require communications between auditors and the audit committee on key issues such as the independence of the auditor, the quality of management's accounting estimates and judgments, and the identification and explanation of unadjusted differences in the financial statements. They also require audit committees to meet at least four times a year to discuss matters pertinent to good financial reporting, such as management letter comments, accounting issues relating to potentially problematic projects or transactions. This requirement that the independent auditor provide the audit committee its opinion on the quality of management's accounting estimates and judgments was a *significant improvement*. Previously, management could technically be in compliance with GAAP, but perhaps not be fairly reporting its financial results. Witness Enron's disclosure of its innovative use of "special purpose entities." The disclosure was buried in the financial statements, but nevertheless was picked up by a couple of analysts who took issue with the strategy's appropriateness, but missed or ignored by the rest of the world, including an under-funded, over-worked

SEC. It is essential to ensuring that the Audit Committee is aware of just how conservative or aggressive the company's accounting practices are. The rule-based requirement that the disclosure be made makes it easier for the auditor to sound an alarm if necessary.

The requirement of private sessions between the outside and internal auditors was also an innovation that fosters free and open communication. Inclusion of this mandate in listing standards in 1998 was the first step in making the outside auditors ultimately accountable to the Board of Directors rather than management. Recent changes to listing standards went even further in fostering open lines of communication and thus assisted the Board of Directors in carrying out its oversight responsibilities by requiring private sessions with members of management and that management report and discuss a range of corporate information beyond quarterly and annual reports. For example, the June 2002 amendments to national listing standards require management to discuss with members of the board, specifically audit committees, the company's risk assessment procedures, risk management policies, and compliance and regulatory matters. This "new rule" is in fact a "best practice" that has been followed by major corporations for a number of years to a greater or lesser degree. It is the independent director's job to listen and question what is being said and insist on an appropriate response from management. Directors should shy away from the latter role. It is essential to effective oversight. A key change however is the requirement that the independent auditor report to the committee any concerns it has in this area.

Furthermore, Sarbanes-Oxley as implemented through SEC rules requires the CEO and CFO to certify the accuracy of the company's financial statements to the audit committee. This requirement is new and represents a major development in that it requires communications between the audit committee and executive management in a critical area where previously such communications were limited to those received on a periodic basis from the internal and external auditors. It is, in my view, a significant step forward for several reasons. The requirement calls for senior management, particularly the CEO, to focus in a very meaningful way in the preparation of the financial statements and most particularly in accounting estimates and judgments. This requirement has brought about considerable changes in the attitude and the process by which financial statements are prepared. Persons involved in that process (which depending on the size of the company may number in the dozens OR the hundreds) truly reflect on the significance of what they know before signing affidavits attesting to financial statements. In addition, both Sarbanes-Oxley and the NYSE listing standards require the CEO to report to the audit committee, on at least an annual basis, on the adequacy of the design of the company's internal control system and on its ef-

fectiveness. The independent auditors are required to attest to management's assertion. As good internal controls are at the heart of the reliability of good financial reporting, this single new rule provides more comfort as an audit committee member than any other rules, ensuring that financial statements are reasonable and fairly stated.

In light of the recent trend towards specifying the duties of directors in increasingly detailed rules, it is appropriate to emphasize an important point. Independent directors will not become "god" directors simply by focusing on "jumping through the hoops" rather than really thinking about and becoming engaged in the oversight process. One of the problems with the increased focus on the Board and the emphasis on specific rules is that people become more concerned about touching all the bases rather than exploring and understanding the issues. It bears repeating that it is the independent director's job to question. Pointed questions about accounting practices, risk management, and internal controls should be asked regularly so that all that needs to be said or should be said, are said.

For example, the new NYSE listing requirements mandate that a majority of a listed company's Board be "independent". I happen to agree with this rule; however, it is worth noting that it is not at all clear that requiring a Board to be dominated by "independent directors" as that term is defined in the new NYSE listing standards will inevitably and inexorably produce "good" corporate governance (the Smith Barney findings?). It is worth noting that except for a couple of bells and whistles, the Boards of Directors of Enron, Global Crossing and Tyco met today's definition of "independence" and most certainly met the definition of yesterday. Yet the Board of Enron found it in their hearts to conclude that they could and should waive a corporate code of conduct to authorize the Company's CFO to engage in a business clearly in conflict with the interest of the corporation and its shareholders. The Tyco Board and the General Electric Board had no qualms about approving incredible, at least to us mere mortals, compensation packages for their CEOs. In my view, the reigning definitions of independence do not help those selecting director or serving as a director focus on the attributes at the heart of "being independent". It has very little to do with interlocking directorships, making charitable contributions to an institution affiliated with a director or buying the services or products of a company with which a director is associated. What it is about is the independence of mind and spirit. A director must be prepared to speak his or her mind and to resign from the directorship if necessary.

There are other changes, either mandated or recommended, in the new listing standards adopted by the NYSE, which appear to be designed to eliminate or mitigate the potential for negative consequences of conflicts of interest. Experience suggests that these will be less effective in achieving

their purpose and more burdensome than they are worth. More importantly they may have unanticipated consequences that could prove to be detrimental to a good system of corporate governance.

For example, the notion of a “lead director” promoted by some corporate governance experts has crept into the NYSE listing standards through the requirement that the independent directors designate and identify, in the proxy statement, the director who will preside at the executive sessions of the Board. This misguided rule is apparently premised on the concept that a single director must be named in order to “facilitate communications by employees and shareholders directly with the non-management directors”. This is simply not the case. In fact, anyone who receives a proxy statement or has access to EDGAR will know who the directors are and how to reach them. This concept of designating a Director to lead the private sessions is a bad idea, not just because it is unnecessary, but also because it does not serve its stated purpose, namely to “empower non-management directors to serve as a more effective check on management”. To the contrary, it creates another communication layer and possible barrier between the Board on the one hand and management, employees, shareholders and others on the other. It is simply too easy for that unnecessary additional layer to become a funnel that restricts and limits the flow of communication rather than increases it.

Furthermore, it vests in a single director more authority and power than the others, thereby fractionating the power of the Board as a whole. Furthermore, isolating a single director can make the person more vulnerable to corruption, as occurred in Tyco International. In that case, not only did the presence of a lead director fail to prevent scandal, the director himself had been accused of violating his fiduciary duty.

To be sure, leaders emerge on a Board. To the extent that Board needs to be “led” it is usually with respect to a specific area that falls within the bailiwick of a particular committee. The Committee Chair then is the “ideal” lead director “in situ” that the entire Board addresses specific issues in its private sessions or management as is appropriate. In fact under the current system any director is free to request that items be added to the Board’s agenda or that the Board addresses a specific matter. No director should have to run a gauntlet with respect to such a request.

All directors should have integrity and be vigilant, informed, and independent. They should not be invited to relax and let the “lead director do it”.

An appropriate response to this new listing standard would be to have the Chair of the Executive sessions of the Board rotate among the Chairs of the Company’s various committees. This solution avoids an unhealthy concentration of power and reduces the likelihood of individual director apathy.

A requirement should exist that the Chair of the Audit Committee have an accounting or financial background. Clearly, it did not avoid a financial debacle at Enron or WorldCom. Furthermore, the requirement that the company certify that at least one member of the audit committee is a “financial expert” as defined by the SEC.

Of course, it is important to be able to understand what the CFO and Auditor are trying to tell you about their financial accounting systems and reporting process. Therefore, having people on the audit committee who understand (or who are willing to learn the difference between a debit and a credit) is a place to start. However, an inquiring mind is a more important attribute than technical accounting or financial expertise. The Enron fiasco provides the perfect example of an audit committee that was well qualified and financially very knowledgeable, from the point of view of credentials—and that is all that the rules mandate. Thus, Enron’s demise demonstrates that expert knowledge of accounting, auditing, and finance is no silver bullet. The Chairman of the Enron Audit Committee was the chair of the accounting department of a prestigious university; its members included CEOs and a former regulator of a financial market. So much for technical expertise.

The problem with certification requiring at least one financial expert, and the identification of that person is that there are few if any members of audit committees that are anxious to be labeled as such. In fact, quite the opposite is true!

Clearly, there is no shortage of strongly held opinions and beliefs about what constitutes good corporate governance. As I can tell, for about the past 30 years, corporate governance has been determined by what looks good and sounds right, and less on “what works”. This may not be an area susceptible to strict scientific study, but surely it is capable of analysis with a view, which allows us to draw some conclusions about the “why” of what works and what does not and what generates shareholder value and what does not. Since 1999, a number of changes in corporate governance have been made based on the observations and suggestions of self appointed experts who discuss what “looks good,” “feels right” or “ought to be”. In view of the accepted need for corporations to aspire to high corporate governance standards, it is hoped that someone will conduct a long and rigorous analysis of the situation, and a short study on the moralistic pronouncement on what ought to be.

Salomon Smith Barney has reviewed and summarized the findings of a number of researchers and authors in the areas of finance, economics, accounting and strategic management. Without reading each of the studies, it would be imprudent to rely on the solidity of the researcher’s methodology or soundness of their conclusions. However, Salomon Smith Barney’s paper entitled “Best Practices in Corporate Governance: What Two Decades of

Research Reveals” offers some interesting, if not provable, conclusions. The study focused on published literature on seven topics: Board Compensation, Board Committee Composition, Board and Committee Meetings, Board size, Stock Ownership Charter/Bylaws, and Additional 2003 Criteria based on Sarbanes-Oxley and newly proposed listing standards and looked for empirical support for the prevailing points of view.

Among other things, the authors found empirical support for the propositions that: 1) Independent directors should constitute a majority of the Board; 2) The audit, compensation and nominating committee should consist only of independent directors; 3) The Board should number less than 15; and 4) Directors should be compensated in stock. Whereas, the authors found no or little empirical support for the propositions that: 1) The CEO should be the only insider on the Board; 2) The Board should meet without the CEO; 3) The CEO and Chairman of the Board should be separate; and 4) Those options should be expensed.

In their concluding observations the authors of the Salomon Smith Barney report concluded that no one set of governance rules fit all firms and situations. They correctly point out that for United States corporations it is assumed that the Board’s objective is shareholder wealth maximization. Different regulations, laws and cultural forces may drive the model in other jurisdictions. They recommend that when designing a corporate governance structure, boards and shareholders should take into account the industry, its growth opportunities, its size, and the need for different skills and expertise.

POST MORTEM ON THE 2002 ATTACK ON RESEARCH ANALYSIS: WAS IT JUSTIFIABLE HOMICIDE OR A SALEM WITCH HUNT

The stock market bubble of the 1990s coincided with the growth of the STAR system for analysts employed by financial services companies. Research analysts, whether simply a necessary, and even an essential element in the capital raising and stock brokering business, are the people who supposedly knew the economic fundamentals, and were supposed to be able to inform the public if a company’s business plan and future prospects were good, bad, or indifferent depending upon the circumstances applicable to that company. This perfectly sound process morphed into stock picking contests, and the analyst who got the most answers right was celebrated in the press and compensated by his or her employer like a “Star.” That was the beginning of the end of an honorable profession.